Should There Be Corporate Governance Police?

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If a company misbehaves, lawsuits are one way of providing a remedy and encouraging that company and others to behave in the future. If the misbehavior is securities fraud, there are two potential plaintiffs—traders allegedly injured by the fraud may bring a private suit, and the government (through the SEC or DOJ) may sue to enforce the public interest in truthful disclosures of corporate information. If the misbehavior is violations of corporate governance rules, however, only private suits are available. Despite the parallel rationales for marrying private and public attorneys general, the toolkit for protecting the public interest in corporate governance is not as well stocked. This essay imagines what a government cause of action might look like for alleged corporate governance wrongdoing. Many of the pathologies of current corporate governance litigation may be ameliorated by a state-based, public cause of action for breaches of fiduciary duty. Although not without downsides, putting Delaware's Corporate Governance Police on the beat may improve the governance of American companies, while reducing the amount of vexatious litigation.

I. INTRODUCTION

One of the seminal contributions of Frank Easterbrook and Daniel Fischel (E&F) is the idea of the market as the best available regulator of corporate governance. In *The Economic Structure of Corporate Law*, the remarkable book whose thirtieth anniversary we are celebrating in this inaugural volume of the University of Chicago Business Law Review, E&F note that while "[m]anagers may do their best to take advantage of investors," the

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"dynamics of the market drive them to act as if they had investors' interests at heart."[1] It is a very Chicago claim from two Chicago legends. Three markets—for products, for capital, and for labor—police misconduct by managers charged with spending other people's money. The process E&F envision is a dynamic of trial and error that tolerates losses but *learns*: "The history of corporations has been that firms failing to adapt their governance structures are ground under by competition."[2]

In this claim, E&F echo another legal legend, Oliver Wendell Holmes, who wrote in *The Common Law*, that "[t]he life of the law has not been logic: it has been experience."[3] Here is how E&F put this in the context of corporate governance: "The best [governance] structure cannot be derived from theory; it must be developed by experience."[4] They argue that this is true not just for firms, but states making law as well. (Corporate governance is both state law and the rules put in place by each firm.) Defending the American federalist approach to corporate law, in which states compete with each other in making corporate law, E&F note that "[t]he history of corporate law has been that states attempting to force all firms into a single mold are ground [by the market for charters] under as well."[5] The logic is simple—if a state screws up too much, companies will exercise their right to vote with their feet, choosing a "better" jurisdiction.

But E&F were too smart to think that failure alone was enough to optimize governance for individual firms. Their claim is more modest: "markets bring home to managers *most* of the costs of their suboptimal performance."[6] Markets are imperfect, E&F acknowledge.[7] This means that there will be potentially avoidable failures. If law could efficiently provide remedies for these failures, disappointed investors could be made whole, and the system could learn better, faster.

What can fill the gap between what the market can provide and the optimal governance regime? E&F raise one possibility: "[i]f the legal system offered a better (cheaper) way, courts should use their comparative advantage . . . ." to improve corporate

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1 FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 4 (1991).

2 *Id.* at 13.

3 OLIVER WENDELL HOLMES, JR., THE COMMON LAW 1 (1881).

4 EASTERBROOK & FISCHEL, *supra* note 1, at 5.

5 *Id.* at 13.

6 *Id.* at 98 (emphasis added).

7 *Id.*

governance through litigation.[8] On this point, however, E&F are not sanguine— "courts are [not] well suited to detecting and rectifying shortcomings in the boardroom . . . ."[9] E&F are Chicagoans, after all, so they fall back on the work done by the three markets as doing as well as we can do.

But, as powerful as these markets are and as right as E&F may be at some level, we should not just take their word for it and call it a day. Rather, it is always worth looking under rocks to see whether there are devices available that can improve governance. The first-best governance may be out of reach or too costly to achieve, but there may be improvements on the margin that may be discovered. One can read E&F as merely telling us to be careful when doing so. We should be humble about what we can devise in our minds or laboratories. It is incredibly difficult to create something that will obviously make things better, and we should be especially leery of imposing a "solution" on every firm without the ability to opt out. Local maxima are everywhere. And, as in other areas of law and life, we should be skeptical of those who think they can immanentize the eschaton. The lesson from medicine applies to potential corporate law reforms—first, do no harm. But we should always be looking.

So, what could be tried that might shrink the wedge between the discipline of the three markets and more optimal governance? This Article takes E&F up on their suggestion about courts by proposing a mechanism that *might* be a way for the legal system to better police corporate governance. The idea is simple: create a *public* cause of action for breaches of fiduciary duties owed to shareholders. For example, if managers violated the duty of loyalty by engaging in self-interested behavior, they could be prosecuted not just by aggrieved shareholders, but by lawyers representing the public interest. Instead of (or in addition to) *Smith v. Van Gorkom*,[10] we might see *State of Delaware v. Van Gorkom*. Enforcement could be handled through existing state resources or, perhaps even better, a special unit—the "Corporate Governance Commission"—whose sole responsibility would be to identify, investigate, and prosecute alleged breaches of fiduciary duties. Delaware could have corporate governance police.

The goal of this Article is not to set out the details of such an agency or even to lobby for its creation, but rather to pose the question and wonder at possibilities. This is not just inspired by

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8 *Id.*
9 *Id.*
10 488 A.2d 858 (Del. 1985).

E&F but consistent with their view that we always stumble in the direction of the optimal (or perhaps second-best) corporate governance regime. The question it begs is whether the stumbling done through litigation today is sending us in the right or the wrong direction.

This thought experiment parallels a feature found in the other area of litigation-based regulation of corporate conduct—securities fraud suits. If a company lies to its shareholders, there are two types of possible suits that may arise: first, a private securities fraud class action brought on behalf of shareholders; and second, an enforcement action (either civil or criminal, or both) brought by the government on behalf of shareholders, investors generally, and the public at large. But, if corporate directors violate their fiduciary duties to shareholders, only private (derivative) suits are available. There are no corporate governance police. There is no Securities Exchange Commission walking the beat of corporate board rooms.[11] This Article wonders whether there should be.

II. PLAINTIFFS IN CORPORATE LITIGATION

At root, the question this Article takes up is this: who is the best plaintiff in cases of alleged breaches of corporate governance norms? In corporate litigation, there are three possibilities.

The first and most obvious is the corporation itself. Although a legal fiction, the "body corporate" is the entity harmed by most breaches of fiduciary duties. If directors engage in self-dealing or the CEO steals from the till, the company is harmed. There is no company—it is just a legal fiction—so this is just shorthand for saying that everyone involved in the company—shareholders, creditors, employees, customers, suppliers, communities, etc.—is harmed. There is less available for all than there should be. As plaintiff, the corporation can decide whether and how to proceed with the litigation, cashing out the heterogenous preferences of various stakeholders to maximize the value of the corporation as a whole. After all, a cause of action is an asset of the corporation, just like any other project, and the costs and benefits of pursuing

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[11] The SEC tried to police corporate governance through securities fraud suits. In Santa Fe Industries v. Green, 430 U.S. 462, 475 (1977), however, the Supreme Court held that breaches of fiduciary duties to minority shareholders are not securities fraud. Nevertheless, scholars believe that the failure of Delaware to adequately protect corporate governance has led to large-scale usurpation by federal law. *See, e.g.*, Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 860 (2003). As discussed herein, this is likely a mistake.

a claim, how to settle it and on what terms, and so on, is a business decision. State law empowers boards to make all business decisions. If the claim is worth five million dollars to the company in expectation, the board is arguably best positioned to determine whether the sum of direct and indirect costs of pursuing the claim are worth it. If these are greater than five million dollars, the suit will not and should not be brought.

Directors may not be the best plaintiff in these cases for several reasons, and because of this, shareholders may step into their shoes and act as plaintiffs in a limited number of cases. The issue is that directors may have a conflict of interest since they may be suing themselves or their colleagues. Even a director that satisfies all the tests of "independence" might not bring a net present value (NPV) positive case against another director out of concerns of being socially isolated or a sense that "there but for the grace of God, go I." As the Delaware Supreme Court has noted, directors are "not merely homo economicus" and instead are motivated by things like "love, friendship, and collegiality."[12] "Some things are just not done," the Delaware courts remind us,[13] and one of these things might be suing other directors. Accordingly, we expect that some suits that are in the best interests of the corporation would be pushed under the rug by directors. This harms shareholders and the larger web of corporate stakeholders. In short, there are agency costs in the management of litigation, just as there are in the management of the company, which of course give rise to the litigation in the first place.

The solution law uses to optimize along the tension inherent in these first two options—directors or shareholders as plaintiff—is the demand requirement. A truly Byzantine procedure, the essence is that the board is the presumptive plaintiff for corporate governance violations, and therefore shareholders with a grievance must first ask the board to sue. Only if the board is incapable of being an adequate plaintiff, because of a majority being interested in the dispute or being dominated by those who are, can the shareholder sue.[14] The Delaware dance, requiring courts to decide whether demand was excused as futile or whether a "special litigation committee" was independent, did an adequate

12 In re Oracle Derivative Litig., 824 A.2d 917, 938 (Del. Ch. 2003).

13 *Id.*

14 *See, e.g.*, United Food & Com. Workers Union v. Zuckerberg, 250 A.3d 862, 876 (Del. Ch. 2020).

investigation, and reached a reasonable conclusion,[15] is aimed at picking the best plaintiff.

Shareholders might bring frivolous suits or settle on terms that serve the interests of some shareholders and not others, while the board might be disabled from making a choice that serves the interests of the corporation as a whole. The cost of the legal system reaching a verdict is sufficiently large in corporate fiduciary duty suits that allowing a plaintiff to get past the motion to dismiss can result in a substantial payout, regardless of guilt. The demand-dance presses the resolution based on a peek at the merits at the motion to dismiss phase in order to address this concern. But by not allowing plaintiffs to take discovery, it hampers the pursuit of truth. Good claims might not get brought because of the inability of plaintiffs to get all the facts. The result of the struggle to choose among these first two options is that corporate fiduciary duty litigation is rare, highly uncertain, and very costly.

The third possible plaintiff is the government. So far Delaware has not considered this option. Public causes of action, along with private ones, are familiar for a wide range of wrongs, from violent crimes to securities fraud. (In fact, in most areas, we think of the public cause of action as the primary one, and the private cause of action as the secondary one. There are, for example, civil suits for criminal acts, but we think of these as secondary to the primary role of government in policing criminal activity.) Civil and criminal suits, or private and public suits, have different goals and ends. In addition, having private suits permits public prosecutors to conserve limited resources and to target them on matters most impacting the public. The use of "private attorneys general" is familiar.

There are several reasons why it might make sense to create a public cause of action for corporate governance violations. There are reasons internal to the litigation or firm, and reasons external to the litigation or firm.

With regard to internal matters, the provable shareholder losses (i.e., damages) may be insufficient to cover the costs of litigation or to motivate lawyers to take the case. If the litigation costs $120 to bring to conclusion, but damages are only $100, shareholders won't bring the suit at all, leaving the governance failure unremedied. Smaller harms (which may still be significant, especially when aggregated) may be undeterred and shareholders worse off—in this case, by $100. Government lawyers are

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15 Zapata Corp. v. Maldonado, 430 A.2d 779, 788–89 (Del. 1981).

not primarily motivated by financial returns and therefore are more likely to take cases with a low expected value, or even a negative expected value, from a purely monetary perspective. If we believe that the $120 cost reflects something about the social costs of bringing the litigation, then one might not think the failure to bring a case in this hypothetical is a bad thing. But the costs of the litigation have nothing whatsoever to do with the losses suffered or the social harms. One might say that public prosecutors should not sue in this case either, which would be true if the $100 reflected the total social value. But, as discussed below, there will be cases in which it does not, and private lawyers would still not sue.

Even if the economics work—e.g., the suit would return $200 to the company and only cost $120—the board might be able to dismiss the case under the demand process mentioned above. Plaintiffs have to show that a majority of the board is interested in the litigation or otherwise unable to make a good decision, which is a tough standard to meet. It likely permits boards to get rid of meritorious cases simply because the plaintiff cannot provide evidence of bias. Plaintiffs must rely on publicly available materials—the "tools at hand"—and this hampers the prosecution of such claims. The government could possibly target these cases—where the allegation is strong but the plaintiffs cannot show the board is disabled from deciding about whether to bring the case. As discussed below, the government is not limited to the "tools at hand," but rather it can use subpoenas and conduct investigations without first proving to a court that it is the best plaintiff.

In addition, a board that is doing its job seriously and is not conflicted might dismiss meritorious litigation because of non-economic factors, such as reputational harms or managerial distraction. By de-personalizing litigation, the government can also overcome these problems in a limited set of cases. Whether this would be a good or bad thing for shareholders is ambiguous, turning on whether the board is accurately assessing these factors. The government might make mistakes too, and it should consider these kinds of costs. But, over time, government lawyers might develop a better view of these across a wider range of cases because they are repeat players. Recognizing that these supposed costs might be overestimated as just a way of getting rid of meritorious cases, government lawyers might be able to alter this dynamic.

There may also be externalities from the misbehavior of corporate officials. Corporate governance violations may cause harm to non-investors, might spill over to other firms, and may impact capital markets. There are several varieties to mention briefly.

First, the impact on the public (as distinct from shareholders of a particular firm) from breaches of fiduciary duties are potentially significant. Governance failures may cause harm to people other than investors—workers, suppliers, customers, and other corporate stakeholders. For example, directors that put their self-interest above the corporate interest in a deal may cause it not to be done when it would have generated welfare gains for corporate stakeholders. If there are significant harms to the public beyond those suffered by shareholders, then it is not enough for shareholders to be the only ones that can sue. This is in part about damages. If investors suffer $100 in losses, but the social harm from a governance failure is $200, then a shareholder-only litigation model is insufficient as a source of remedy and change. Directors caused $300 in damages in this example but are on the hook for a maximum of $100. They will be under-deterred. The result is too much of the harmful activity, in this case, lax corporate governance. (And, of course, if the litigation costs $120, it won't be brought by private lawyers, even though it is socially NPV positive.)

Underenforced governance obligations may also have spillover effects by eroding the quality of governance in other firms. If the firm that caused $100 in losses to shareholders "gets away with it" (because a suit would cost $120, for example), then other companies in that industry or geography or the like may cheat a bit on governance, believing this is the new baseline. A "culture" of underenforced governance quality can arise in a particular location, industry, or time, and thus cause losses that, while insufficient to generate a lawsuit in any case, add up to significant social harm. For instance, continuing the example from above, imagine there are ten firms in an industry that each are lax with governance, and thus generate shareholder losses of $100 in each case, but that it would cost $120 to bring any case. Social losses of $200 per case are also caused. Investors suffer $1000 in losses, while society suffers $2000. And yet we would expect no suits. Investors cannot sue across many firms, even if they are investors in all of the companies. And there is no cause of action for the public in such cases. What is needed is a mechanism for aggregating across many firms and incorporating social harms. The shareholder derivative suit addresses one source of a collective action problem (among shareholders of a given firm) by collecting damages at the firm level, where all shareholders share and share alike. But these other collective action problems are not addressed by existing litigation.

The losses may also cascade to capital markets, causing a misallocation of resources in the economy. Governance failures may lead to bad deals, inflated asset prices, dashed expectations of investors and others, and a host of other financial and non-financial impacts that may cause capital to be misallocated. For instance, if minority investors are abused, they will not invest or do so on terms that reflect the risk of being exploited. Money will sit on the sidelines or be invested with a large expected return. This raises the costs of capital, which reduces the number and type of projects companies can and will do. Society is harmed because there is less economic activity. Selfishness or extreme sloppiness by directors can distort stock prices and the efficiency of capital allocation as much as securities fraud. In fact, the SEC and the Supreme Court recognize this and other potential spillovers involved in breaches of fiduciary duties in the cases prosecuted for insider trading under theories based on such breaches.

All of these potential negative spillovers are at least as large as in other areas—such as securities fraud—where there exist private and public causes of action.

III. Picking the Right Plaintiff

How should we think about picking the right plaintiff for a particular dispute? The question is critical, as it determines the quality of law through case selection and execution. If certain types of cases are not brought or too many of one type of case are brought, the path of the law will be warped or distorted. For instance, if plaintiffs are motivated primarily by monetary returns, then large-dollar cases will predominate over small-dollar ones, and if the latter are different in substance, then law will be biased in a particular direction. Not to mention that justice will be less likely to be done in the small-dollar cases.

Three big things matter in choosing the best plaintiff.

First, case choice matters. We want plaintiffs to bring all cases in which there are substantial harms that flow from the conduct of the action. In the example above, if the $300 in social damages is significant, all interests considered, we want this case to be brought, regardless of whether the case is a "money maker." It is for this reason that it is common for there to exist both private and public causes of action in parallel. Ideally, private lawyers would go after high-dollar-stakes cases, while public lawyers would go after high-social-stakes cases. This division of labor would help ensure that all high-stakes cases are brought. The potential allocation of societal prosecutorial resources is shown in Figure 1 below.

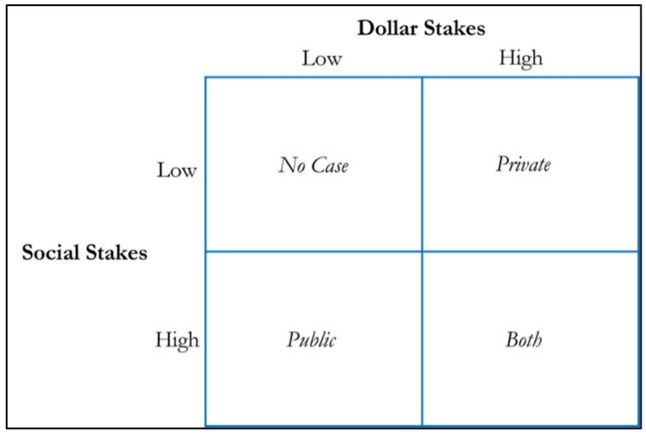

Figure 1: A Framework for Allocating Prosecutorial Resources

There is another dimension to this, because even high-dollar-stakes cases might not be brought by private plaintiffs. As discussed below, there may be social norms, family reasons, or other factors that prevent certain cases from being filed. For instance, anecdotal evidence from market participants suggests that venture capital-backed companies are commonly falling short in terms of governance, and yet there are very few cases brought. This may have to do with the fact that failed entrepreneurs blame themselves or their ideas, not governance. Or, perhaps they don't want to get a reputation in the Valley for being litigious. Who will fund their next big idea?

Causation may be tough to prove in such cases too. After all, we have no good way of separating the value of governance from economic performance generally, and so the failure of a company can just as easily be blamed on market downturns, bad products, poor marketing, or a host of other reasons. So long as there are plausible alternative stories, damages from bad governance will be too speculative. The procedural barriers described above—the board gets to control the litigation unless it is not independent—mean there are additional costs of bringing these suits. First, private lawyers have to prove they should have the right to sue, and this may be extremely expensive. If they get past that, then they have to prove the failure and overcome the argument that damages are too speculative. Contingency fees in such cases may be insufficient to justify an investment, meaning an entrepreneur coming off a failed start-up may find even a valid claim orphaned.

Second, the quality of lawyering matters. Getting the "right" plaintiff may in fact be a proxy for getting the best possible lawyer to bring the case. One could endlessly debate the quality of government versus private lawyers, but let us put that charged topic to one side. Quality may be a bit in the eye of the beholder, and whatever one thinks of the relative quality, this factor is likely swamped to some extent by the issues of case selection discussed above and incentives discussed below. It is worth mentioning, however, that if a state were to create a public cause of action, ensuring that the lawyers responsible for bringing cases would be a paramount consideration. One would want them to be comparable to the lawyers that currently bring corporate governance suits.

Moreover, what really matters is the motivations of the lawyers and their willingness to press all of the interests at stake in the case, not just their private ones. Along this dimension, government lawyers might be superior (all else being equal) in certain types of cases. One would hope that any state-based lawyers pressing governance matters would attract high-end talent and inculcate a culture of public-interest-serving norms, akin to how the SEC and DOJ are widely regarded. In this ideal scenario, it is difficult to believe that the set of cases in which government lawyers might be superior is empty.

Finally, the incentives of the plaintiff to bring, press, and possibly settle the case are an important criterion for setting the optimal plaintiff. Here again, there are tradeoffs. Government lawyers have the power of the state behind them and are able to use subpoenas and other forms of coercion unavailable to private lawyers. Stephen Bainbridge highlights the importance of the power of the state to compel in the regulation of insider trading:

> This condition holds because the police powers available to the Commission, but not to private parties, are essential to detecting insider trading. Informants, computer monitoring of stock transactions, and reporting of unusual activity by self-regulatory organizations or market professionals are the usual ways in which insider trading cases come to light. As a practical matter, these techniques are available only to public law enforcement agencies. In particular, they are most readily available to the SEC. Unlike private parties, who

> cannot compel discovery until a nonfrivolous case has been filed, the Commission can impound trading records and compel testimony simply because its suspicions are aroused. As the agency charged with regulating broker-dealers and self-regulatory organizations, the Commission also is uniquely positioned to extract cooperation from securities professionals in conducting investigations. Finally, the SEC is statutorily authorized to pay bounties to informants, which is particularly important in light of the key role informants played in breaking most of the big insider trading cases of the 1980s.[16]

While corporate governance violations differ from insider trading violations in important ways, the power of government investigators to uncover and deter fraud is arguably much stronger than private lawyers. It is true that private lawyers frequently resort to confidential informants, but there can be little doubt that a government agency can overcome the biggest hurdle in policing corporate governance violations—the ability to get discovery before filing a lawsuit and overcoming a motion to dismiss the case for failure to make demand. As noted above, the demand dance in Delaware requires that plaintiffs show making a demand was futile, and they must do so using only the "tools at hand"—public materials. This severely hampers uncovering corporate governance wrongdoing. Government subpoena power, investigations, audits, and the like are not an unalloyed good. There are downsides to permitting government agents to obtain and review corporate board meeting notes, emails, and other corporate documents. If the corporate governance police were ever created, much thought would have to be given to its ambit, its rules of the game, and, most importantly, its people. Fortunately, the federalist approach to corporate law provides something of an escape valve for big mistakes in these matters.

Another upside of government lawyers is that they are focused on all harms (internal and external, monetary and non-monetary, etc.) as compared with private lawyers, who are generally focused only on maximizing their net return. Government lawyers are compensated with low-powered incentives, which means they have incentives to bring cases based on the impact on society, not just on the dollar amounts at stake. On the other hand, the large dollar amounts at stake in some cases may

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[16] Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1263–64 (1995).

motivate private lawyers to uncover wrongdoing, invest heavily in proving their case, and demand the maximum possible settlement. High-powered incentives may be ideal for certain cases. And, although government lawyers have low-powered incentives in terms of dollars, they have high-powered incentives in politics and grandstanding for the public. This important matter is discussed briefly below.

IV. WHERE THE GOVERNMENT MAY BE THE RIGHT PLAINTIFF

The practice of corporate governance in Delaware supports the theory about a potential mismatch between social harms and suits brought by private litigants. While the best available evidence suggests there is a lot of corporate governance litigation in state courts, it is warped in asocial ways by the incentives of the current litigation system. There are several areas where the current state of corporate governance litigation suggests a potentially beneficial role for government litigation. Some of these involve the possibility of too much litigation, while others raise concerns about there being too little litigation. These are raised briefly below. More work should be done to put flesh on these bones.

Private companies. The vast majority of governance litigation in Delaware targets public companies. This is strong evidence of a mismatch between the subject of governance wrongdoing and the object of fiduciary duty litigation. The reason most suits involve public companies is the same reason bank robber Willie Sutton robbed banks—it is where the money is.[17] Public companies are bigger, richer, in the public eye, and hire better (more expensive) lawyers than private companies. This makes suing them to extract a settlement more attractive. It is not at all clear, however, that this is where most corporate governance violations are, or where, including all the social and private costs of violations, the net harms are the greatest.

There are about 1.6 million business entities registered in Delaware, with the overwhelming number being corporations or limited liability companies.[18] Only a couple thousand of these are publicly traded.[19] But *public* companies are the vast majority of

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17 Willie Sutton, FED. BUREAU OF INVESTIGATION, https://perma.cc/Y8NX-2HTG (last visited Feb. 9, 2022).

18 *2020 Annual Report Statistics*, DEL. DIV. OF CORP. (2021), https://perma.cc/X98U-4AE6.

19 Vartika Gupta et al., *Reports of Corporates' Demise Have Been Greatly Exaggerated*, MCKINSEY & CO. (Oct. 21, 2021), https://perma.cc/S38N-MD92 (finding there are

corporate governance defendants in Delaware. Robert Thompson and Randall Thomas report that in the years they studied, "[a]lmost all shareholder litigation in Delaware is against public companies (91 percent: 952 of 1048)."[20] Assuming governance wrongdoing is equally distributed among a few thousand publicly traded companies and more than a million private companies, one would expect that the amount of private versus public litigation would reflect this overwhelming ratio of private to public companies. About 99.8 percent of companies in Delaware are *private*, but about 91 percent of litigation is against *public* companies.[21] To believe that there is not a bias in favor of public company defendants, one would have to believe that publicly traded companies are more beset with governance problems. Vastly more. To be sure, the diffuse ownership of public companies might suggest larger agency problems, all else being equal. But, on the other hand, public companies are subject to much more scrutiny by markets, the media, and stock-market regulators, both public and self-regulatory organizations. A fortiori, it is hard to know whether to expect more governance wrongdoing from public or private firms. But it is difficult to believe that the suits we see reflect the underlying incidence of misbehavior. This is especially so because, as discussed below, there is strong anecdotal evidence that governance standards are much lower in private companies, including venture backed companies and family firms.

In addition, there is a compelling reason why public companies are the defendants in almost every case—public companies are more lucrative targets. Public companies are larger, wealthier, likely to spend more in defense, and bear large reputational damages from any suit. This means the strike value of any suit is much greater. Since almost every case settles, it is likely that this value matters much more than the amount or magnitude of wrongdoing. Consider two cases. In the first, the plaintiff has a 100% chance of winning, and the expected damages are $1 million against a private company; in the second, the plaintiff has a 10% chance of winning, and the expected damages are $100 million

between 4,000 and 5,000 publicly traded companies in the United States); *see also* Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2509 (2005) (finding Delaware is home to about half of U.S. publicly traded companies).

20 Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 167 (2004). *But see* Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, 51 WM. & MARY L. REV. 1749, 1770 (2010) (reporting a slightly lower percentage based on cases filed from 2004 to 2005, with about 78% of cases against public companies).

21 *See* Thompson & Thomas, *supra* note 20, at 167.

against a public company. The first is worth $1 million (gross), in expectation, and the second is worth $10 million (gross). Any rational (non-governmental) plaintiff will choose the much weaker case, assuming that the defendant will settle for something around the expected value prior to trial. This is true even though the wrongdoing was worse in the first case against the private company. Although the expected value is less, the wrongdoing is certain, and the case against the public company does not satisfy the preponderance test of more likely than not that there was even any wrongdoing. A government plaintiff, being less interested in the financial return, is much more likely to choose the case involving the bigger governance wrongdoing.

Mergers & Acquisitions. Boards are heavily involved in transactions to buy and sell companies, and it is here where potential conflicts of interest can have large effects on shareholders. It is no surprise, then, that a lot of corporate governance litigation involves mergers and acquisitions. While there is the potential for board members to be sloppy or disloyal in approving a transaction, the amount of litigation is excessive by any measure. In the period from 2009 to 2015, lawsuits were filed in nine out of every ten deals, and approximately five lawsuits were filed for each deal.[22] These suits were overwhelmingly "strike suits," settling out of court for changes in disclosures (which did nothing for shareholders) in return for large payouts for lawyers. Although the Delaware courts have tried to limit these bogus suits,[23] plaintiffs decamped to federal court and used new strategies, such as deeming a suit "moot" instead of proposing a settlement, to avoid the Delaware skepticism. There are still suits filed in nearly eight in ten cases, and each deal generates about three lawsuits.[24] Not only are most of these suits of questionable merit, but the attempt to limit them is also concerning. Using courts to limit causes of action could be a sledgehammer approach, discouraging meritorious suits as well. In fact, there may be meritorious M&A suits that are not currently being brought because of the economic realities of corporate litigation. A government plaintiff might be able to better identify actual breaches of fiduciary duties (using whistleblowers or confidential informants), to bring suits against all types of wrongdoing.

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22 Ravi Sinha, *Shareholder Litigation Involving Acquisitions of Public Companies Review of 2018 M&A Litigation*, CORNERSTONE RSCH. 3 (2019), https://perma.cc/GM2V-6FUU.

23 *See* In re Trulia Inc. S'holder Litig., 129 A.3d 884, 892 (Del. Ch. 2016).

24 *See* Sinha, *supra* note 22.

A public option would not necessarily get rid of the excessive suits directly, unless the new Corporate Governance Commission (CGC) were given exclusive jurisdiction, something that seems very premature. The most immediate benefit then would be the suits that are not being brought. But one can see how the presence of the CGC may have a positive effect on raising the costs of strike suits. The fact that the CGC investigated a matter and chose not to sue might be information that courts and defendants could use to get rid of bogus suits. The fact that the SEC has investigated a case of potential securities fraud and declined to pursue the matter is regarded as an important input into securities cases. Moreover, the CGC could develop guidelines over time that reflect its views about the indicia of good and bad governance generally or in M&A cases specifically. These could then be adopted by parties, thus further insulating cases from potential strike suits.

Venture capital. The stakes of corporate governance are arguably higher in Silicon Valley than anywhere else. Silicon Valley is the incubator of America's next big companies. Bad governance can kill even promising companies, especially in their infancy. For those that can survive, getting governance right at birth is also important at ensuring quality governance practices endure.

The stakes are high, and the performance of corporate governance is low. One venture capitalist recently summarized the consensus view, describing Silicon Valley as "a 'Wild West' where rule-breaking is a foundational principle."[25] One reason for this may be the economics of venture capital investing. If a typical fund lasts ten years and expects a return of 12% per year, the fund must triple its investment to satisfy expectations.[26] This is not easy to do with investments that turn out reasonably well. To see this, consider a fund that makes 10 investments of $10 million, getting 25% equity in each company. Each of these companies is worth $40 million at time of investment. A good result might be five of the ten companies surviving, exiting at a value of $50 million, four of them doing well, exiting at $100 million, and one doing outstanding, exiting at $500 million. But, in this case, the fund returns only $287.5 million, less than its expectations. If instead, the fund has nine total failures (exits at zero) and one home run (and exit at $1.25 billion), it can return $312.5 million to investors. This is the hunt for "unicorns" that drives investment decisions. While there is nothing wrong (and a lot right)

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[25] *See* Scott Lenet, *Venture Capital Desperately Needs More Governance*, FORBES (June 20, 2019), https://perma.cc/UP8T-R5EF.

[26] $1.12^{10}X=3.1X$, where X is the amount invested.

with a system of diversification that allows big bets on world-changing companies, there is a potential downside. The nine companies in this latter example may have their choices altered along the way in socially suboptimal ways as the venture capitalists encourage riskier and riskier bets. If the choices are merely this project or that project, then the law has little to say. But if the choices are distorted by bad governance, there may be a role for law to play.

The typical bad-governance scenario involves the conflict that arises between venture capital investors (who hold preferred shares) and founders and employees (who hold common shares). In so-called "down round" financings or decisions about selling the company, these different capital positions generate conflicting interests and the possibility of self-dealing.

For instance, in *CDX Liquidating Trust v. Venrock Associates*,[27] a start-up company called Cadant needed a bridge loan to survive, and it turned to a syndicate led by its venture capital investor. The company eventually defaulted on the bridge loan, and under its terms, the venture capital fund wiped out all of the common shareholders' equity, gaining total control over the company. Remarkably, the negotiations for the loan on behalf of Cadant were led by a board member who was a partner at the venture capital firm leading the down-round investment. The obvious and irredeemable conflict of interest—the board member was literally negotiating against himself—did not dawn on any of the parties, including the lawyers, until the eleventh hour. The board member tried to insulate his egregious conduct by merely not voting.

The defendants argued that disclosure of the conflict and approval by the board cleansed the transaction, and the district court agreed. Writing for the Seventh Circuit, Judge Posner disagreed, remanding for a new trial (and assigning a new judge to boot).[28] *CDX* is remarkable in that the parties, including a prominent venture capital firm, thought this kind of behavior was acceptable. If this example is indicative, governance standards are extremely wanting.

But, more importantly for current purposes is how the case made its way to court in the first instance. Cadant ultimately failed, and the assets of the company, including the right to bring a lawsuit against the conflicted director, were purchased out of

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27 640 F.3d 209, 212 (7th Cir. 2011).
28 *Id.* at 220.

bankruptcy by an attorney who had invested in the company.[29] It was just a fluke. The lawyers involved in the case told the author that suits against venture capitalists are rare, in part because entrepreneurs are reluctant to sue venture capital firms, as they expect to be in need of venture money for their next big idea, and the community is relatively insular and unforgiving. If this is true, as the Wild-West descriptions suggest it may be, then there is a suboptimal amount of governance litigation in venture capital-backed companies.

Family Firms. Another area where there may be a suboptimal amount of corporate governance litigation is in family-run firms. Most businesses in America are run by families, and families are, of course, beset by rivalries and bad behavior, just as other companies are—perhaps more so, as *King Lear* teaches us. When agency costs are mixed with sibling rivalry, the result can be corporate warfare unlike that seen in more transactional public companies. In a recent case in which the author was involved as a governance expert, the second generation of a family-run company was involved in open warfare about governance, information sharing, compensation, and corporate strategy. The personal nature of many of the claims was unmistakable. The intensity of the conflict, the way that the litigation was run, and the inability to resolve the dispute amicably had the unmistakable stink of a family squabble. In such instances, we may see excessive litigation or more intense litigation than is socially optimal.

On the other hand, there may be instances in which family firms are less likely to use litigation because of the trusting nature of some family members. Family members in charge may be able to get away with much more because of the goodwill inherent in the blood relation.

A fortiori, it is unclear whether we expect to see too many or too few suits in family firms, and, for the suits we see, whether they are characterized by more personal (and therefore less rational) litigation tactics.

A government plaintiff in these cases could easily address the cases that are not being brought by family members out of deference to other family members or for fear of being socially ostracized. Addressing any excessive litigation would be more challenging since the existence of a government plaintiff would not necessarily preclude a private one from bringing a suit. But, as discussed below, there are ways of addressing this concern.

29 *Id.* at 209.

Public companies. Although, as noted above, public companies are overwhelmingly the object of corporate governance litigation, there may still be a suboptimal amount of litigation against public companies. That is, the number of suits may be less than the level of corporate governance wrongdoing above a certain level, and governance could be improved (both at targets of litigation and more generally) by more/different governance suits. There are several reasons to believe this may be true.

First, the economics of these cases dominates the level or scale of wrongdoing. The analysis is the same as discussed above as between public and private companies.[30] If lawyers have to choose between bringing a weak case against a huge company and a strong one against a small company, there is no doubt which one will be brought. Unless all cases are brought (which is unlikely for the reason given below), this means the probability of being sued will be greater for larger companies, leading to underdeterrence for smaller ones. The use of frivolous suits as a way of shaking down large companies also erodes governance, in that it demeans lawsuits as governance control mechanisms in the eyes of corporate executives, who then view the law as arbitrary. If governance is just box checking and the occasional lightning strike, then governance will erode.

One might think that lawyers would bring all NPV positive litigation, but this leads to another potential reason why there are not enough corporate governance suits—the economics may not work for cases against smaller defendants. Discovering wrongdoing, getting over demand futility hurdles, and making a case through discovery past summary judgment is uncertain and expensive. Given the large fixed costs, there will be a bias against suing smaller defendants, leading again to potential underdeterrence.

As noted above on the economics of these cases, governance failures may not lead to large enough harms to justify a lawsuit (even a class action), while the social harms may be sufficient to justify government action. It is for this reason that the allocation of prosecutorial authority in the range of cases is commonly thought to permit the government to focus on cases with relatively low dollar stakes, leaving private attorneys general to go after the cases with an expected monetary return. The Federal Trade Commission, for instance, commonly brings low-dollar

30 *See* discussion *supra* Section III.

stakes consumer fraud cases that would not be economical for private lawyers.

There are other reasons, as discussed above. These include problems of detecting wrongdoing and overcoming the defenses corporations have in these cases—including the business judgment rule, waivers of liability under Delaware law,[31] overcoming the demand requirement, the asymmetry of reimbursement for attorneys' fees, and so on. In addition, the vast majority of cases against public companies in Delaware involve mergers and acquisitions. Robert Thompson and Randall Thomas find that about 94 percent of cases in Delaware involve buying or selling companies.[32] Although deals are times of heightened stakes of fiduciary duties, it would be surprising if there were effectively no other breaches of fiduciary duties or other governance violations in all other contexts, ranging from hiring and firing to executive compensation, oversight, and a range of other areas.

Finally, since it is very difficult or impossible to measure the impact of corporate governance independent from corporate performance, the discovery of governance violations and the ability to get damages (which are typically based on stock price changes) will lead to potential under-enforcement of governance violations. For instance, if directors are engaged in corporate governance violations, but the company is nevertheless doing well in terms of economic returns, the violations may be unnoticed or, even if they are noticed, unlikely to lead to damages. Although this problem would still plague government enforcers, it is possible that a professional department would have incentives to invest in/learn about this issue across firms. Experience, as E&F argue, may be as valuable here as in other aspects of corporate governance.

V. Securities Fraud as an Analogy and Open Issues

Securities fraud is a natural analog for the idea floated in this Article. Private and public prosecutors work alongside each other, and sometimes together, to enforce the securities laws. The problem of strike suits and inefficient litigation is also a major concern in securities class actions. In fact, when the Supreme Court curtailed the reach of securities fraud claims for aiding and abetting for these reasons, denying private lawyers causes of action in

[31] Del. Code Ann. tit. 8, § 102(b)(7) (2021) (allowing corporations to waive director liability for breach of a duty of care).

[32] *See* Thompson & Thomas, *supra* note 20, at 168.

these cases,[33] Congress responded by restoring the cause of action, but limiting it to *public* enforcement only.[34] The *Central Bank of Denver* Court and Congress both recognized the general logic set out above about the distortive effects of economic incentives on private litigation.[35] Congress determined that the plague of strike suits that the Court tried to curtail in *Central Bank* (and other cases) did not mean there were not underlying problems of securities fraud. Just that there was a mismatch between the cases being brought and the incidence of fraud. The Delaware Chancery Court in the *Trulia* case made a similar move, trying to curtail disclosure-only settlements in M&A litigation.[36] The Delaware legislature, however, has not responded in an analogous way to section 20(e).

If it did, what would be some of the issues that would have to be addressed?

First, there is the question of jurisdiction. One possibility would be for the public prosecutor to be given exclusive jurisdiction over some or all governance claims. This would be the way of section 20(e) and aiding and abetting liability in securities fraud. M&A cases would be the obvious place to start with such a rule. But, as noted above, it is far too early to make such a bold move. Moreover, any exclusivity might not make sense in the corporate governance realm, given the fact that, unlike in the typical securities fraud case, the *company* is harmed in corporate governance disputes. As such, giving the company or shareholders the power to sue to recoup these losses makes some sense. There are many possibilities one could imagine, from joint jurisdiction to a process whereby the government had the right to bring a case exclusively, but if it refused, the private parties could sue. As noted above, even if the government jurisdiction is merely a supplement, there remains the possibility that this could have a positive effect on reducing frivolous suits.

A final intriguing possibility remains—perhaps shareholders should be permitted to opt into a regime in which the CGC had exclusive jurisdiction. Delaware could set the default rule that provides the CGC with concurrent jurisdiction to bring a suit,

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33 *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 190–91 (1994).

34 Securities Exchange Act of 1934, § 20(e), 15 U.S.C. § 78t(e).

35 *See, e.g.*, *Securities Litigation Uniform Standards Act of 1997: Hearings on S. 1260 Before the Subcomm. on Sec. of the S. Comm. on Banking, Hous., & Urb. Affs.*, 105th Cong. 7 (1997) (statement of Rep. Anna G. Eshoo) ("Without this uniform standard, the law is undermined, the strike suits continue and companies and investors are held hostage.").

36 In re Trulia, Inc. S'holder Litig., 129 A.3d 884 (Del. Ch. 2016).

meaning it could sue on its own or along with private lawyers in a derivative suit. Companies could choose to alter this default rule by putting in their charter a provision that granted *exclusive* rights to sue in all cases (or, perhaps a subset of cases, such as in cases involving M&A or the like) to the CGC. This might be attractive not only because it could nip strike suits in the bud while preserving deterrence, but also because, as described below, by outsourcing litigation costs to the government, it might make economic sense as well. The details of this topic of exclusivity are beyond the scope of this Article.

Second, there is a question about liability. One of the major upsides of using state governance prosecutors is that government can punish in ways that private lawyers cannot. This is not to say that *criminal* sanctions are a good idea for corporate governance violations. In fact, using criminal penalties would have a significant downside of potentially criminalizing socially beneficial risk-taking and deterring even excellent board members from serving. But, short of criminal sanctions, there are many options available to the government, including using fines (e.g., treble damages), bans on individuals serving as public company directors, and other non-monetary sanctions. The SEC and self-regulatory organizations, such as FINRA, use bans as an effective enforcement device. If the public prosecutors stick to damages, they can pay these to the company, making shareholders indifferent between private and public suits. In fact, since shareholders do not have to pay for public prosecution of corporate governance violations as they do for private enforcement, shareholders might strictly prefer public prosecution, all else being equal.

Third, there is the risk of politicization. One of the big risks of prosecuting corporate governance violations with government power is that government, being run by politicians, is always at the risk of being used for political, rather than social, ends. While this is a significant downside risk for any corporate governance police, there are reasons to be hopeful. Delaware has built a world-class corporate law apparatus in which the legislature and judiciary work well to ensure most of America's companies choose it. If the executive branch got involved too, it is likely, in light of this history, experience, and stakes, that Delaware would proceed cautiously in choosing and pursuing cases. In the event that Delaware oversteps, the federalist model of corporate law that E&F highlight in their work would act as a corrective mechanism. If the life of corporate law has been experience, not wisdom, then it is likely true here as well.

Fourth, there is the question about how a new public enforcement approach would interface with federal law and federal enforcement. In a recent paper, Robert Thompson and Hilary Sale document how federal law, specifically securities regulation, has tried to fill the lacuna left by the corporate governance enforcement mismatch sketched briefly above.[37] Most corporate governance is policed through securities fraud class actions, which suffer from their own problems of mismatch, and were not designed in the first instance to address these concerns.

Other scholars have noted this overlap. Jessica Erickson notes that there is a "larger trend of shareholders filing derivative suits on the heels of filing a securities class action."[38] She concludes, however, that there is a difference between derivative suits against public and against private companies. "The public company suits bear a striking resemblance to securities class actions, with shareholders alleging that the defendants caused the corporation to violate accounting rules or mislead its investors," while "[t]he private company suits . . . follow a different mold, reflecting more traditional business disputes or allegations of oppression."[39] It is worth recalling that nine out of ten suits are against public companies, meaning that the current case load in Delaware is largely redundant of securities fraud litigation. A government prosecutor would ideally focus more on the private company suits, which are distinctively state law issues, and even find examples of this kind of wrongdoing, if it exists, in public companies.

Moreover, federal laws, such as the Sarbanes-Oxley Act (SOX) and the Dodd-Frank Act, have directly legislated on corporate governance topics. This has been in part because of the gap left by current corporate governance enforcement. For instance, the internal controls requirements of SOX were meant to address the lack of oversight cases brought in Delaware for misleading accounting.[40] Notably, the federal rules include *criminal* penalties for violations by executives. If there were more rigorous and comprehensive enforcement of corporate governance rules and standards, as a public enforcement arm might provide, these federal interventions might be unnecessary, as in other aspects of corporate governance.

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37 *See* Thompson & Sale, *supra* note 11, at 885.

38 *See* Erickson, *supra* note 20, at 1776.

39 *Id.* at 1780.

40 Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7262.

Erickson wonders whether it is time to "draw the curtain on shareholder derivative suits altogether," since she concludes they are "broken" and in need of desperate reform. One possible reform she suggests is to "restrict the filing of derivative suits to those shareholders who own sufficient stock in the plaintiff corporation to represent the corporation's interests in an effective way."[41] Another reform she considers is "eliminating procedural hurdles such as the demand requirement for shareholders with a sizeable ownership interest in the plaintiff corporation."[42] While these proposals are worthy of consideration, they both rely on large shareholders, such as public pension funds, to pursue governance claims. Although institutional shareholders may have better incentives than the typical strike-suit plaintiff, the upsides they bring could be accomplished by outsourcing governance enforcement to state officials. Pension funds, controlled by labor unions, are not immune to political considerations and, after all, could be suing now but are not. Moreover, as noted above, having the government sue would save the costs and risks of litigation for shareholders. The corporate governance police should be considered alongside her reform proposals.

VI. CONCLUSION

Easterbrook and Fischel set the benchmark for how we think about corporate governance regulation thirty years ago with the publication of their masterpiece. They pointed out the role that markets (for capital, labor, and products) discipline firms and directors, as well as the role federalism plays in producing corporate governance rules. In addition, their work provides a framework for thinking about the incentives of litigation, and how it can lead to a mismatch between corporate governance wrongs and remedies. It would be one thing if the world had listened to E&F, dramatically curtailing corporate governance litigation (not to mention securities fraud litigation) and relying solely on markets to do the work they can do. But there is a lot of litigation in Delaware, and the best read of the evidence is that it is misdirected. It is over-inclusive and arbitrary while also being under-inclusive. There are likely pockets of companies violating corporate governance requirements, but these appear not to be the companies that are being sued. Shareholders are therefore paying for lawsuits they don't need, and not getting lawsuits that they do need.

41 Erickson, *supra* note 20, at 1830.
42 *Id.* at 1830–31.

Lawyers are the only ones that benefit, and the law hasn't figured out how to stop them. The corporate governance police is one idea.

It is hard to know what E&F would think of some form of this proposal, although their work suggests they are likely going to be skeptical. Hopefully they will agree that derivative litigation needs to be reformed and that short of getting rid of it, a public enforcement model is a potentially superior alternative to eliminating the demand requirement or signing over prosecution of these cases to pension funds. Maybe the idea of a charter provision allowing shareholders to opt into a public option will be of some appeal.

But there are no silver bullets here. If there were, they would already have been fired. We are in the E&F world of second bests. As we look out at the world of governance litigation, it is clear that something needs to be done. Some shareholders are paying for lawsuits that serve little to no social value, while other shareholders are abused and their harms are unremedied. Delaware's track record gives us hope that it might be able to create a system of public enforcement that could target the unremedied wrongs while crowding out the frivolous suits that seem so evident.